THE TAX INSTITUTE

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Dear Ms Gainford,

Draft Tax Ruling – Income tax: expenses associated with holding vacant land

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to Draft Taxation Ruling *TR 2021/D5: Income Tax – expenses associated with holding vacant land* (**Draft Ruling**).

In the development of this submission, we have consulted with our SME and Tax Practitioner Technical Committee to prepare a considered response which represents the views of the broader membership of The Tax Institute.

Broadly, the Draft Ruling provides a practical and useful guide for taxpayers seeking clarity around the operation and application of s 26-102 of the *Income Tax Assessment Act 1997* (**ITAA 1997**). However, there are some areas that we consider require further guidance and examples from the ATO, including the application of the provisions to vacant land purchased by Special purpose investment vehicles that are not exempt under s 26-102(5) of the ITAA 1997.

We have also copied Treasury into this submission as there are some key policy considerations regarding s 26-102 of the ITAA 1997. These concerns are shortcomings of the legislation that result in unintended and unreasonable outcomes. These include:

- The operation of the 'affiliate' provision, particularly as it relates to adult children; and
- Unintended policy outcomes under s 26-102(9) of the ITAA 1997.

Our detailed response is contained in **Appendix A**.

We would be pleased to continue to work with the ATO on the development of the Draft Ruling to ensure it continues to achieve its objectives.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact our Senior Advocate, Robyn Jacobson, on (03) 9603 2008.

Yours faithfully,

Peter Godber

President

APPENDIX A

We have set out below detailed comments and observations for your consideration in order to ensure the Draft Ruling provides the best guidance for taxpayers. Our comments broadly follow the order of the sections in the Draft Ruling. All legislative references are to the ITAA 1997 unless indicated otherwise.

Multiple titles of land

The operation of s 26-102(1) has been raised as an area of concern insofar as the provision applies to land used to derive assessable income from residential premises when the land is held across multiple titles. For example, the land-owner may derive income from the lease of a residential premises which consists of two titles. One of the titles may contain the residential premises itself (i.e. a substantial and permanent structure) while the other title may be applied by the lessee for ancillary purposes such as a garage, tennis court or swimming pool. Alternatively, the dwelling may sit astride both titles. In both instances, the outcome under s 26-102(1) is unclear.

We consider that clearer advice, with specific examples in each of these instances, will better assist taxpayers understand and apply s 26-102 to their circumstances.

Determining if a lessee is using land to carry on a business

Example 13 alongside the non-exhaustive list of considerations on paragraph 50 of the Draft Ruling are useful guides that will assist taxpayers determine whether a lessee is in business. We consider that adding the following points to the list will include a broader range of realistic factors that taxpayers can draw from when determining whether the lessee is in business, especially if the lessee is using utilising the land for a purpose ancillary to their business:

- Whether the lessee is involved in any repairs and maintenance of the property or details anyone else who attends to the repairs, under what circumstances that occurs and how frequently;
- How lease payments are determined and how often the amount is changed; or
- Whether the lessee has constructed or restored substantial and permanent structures that indicate an independent purpose (such as those examples in paragraph 10 of the Draft Ruling).

Land in use or available for business

In addition, we consider the Draft Ruling would benefit from a specific example where the land is neither trading stock nor being *physically* used by anyone, yet there are activities being undertaken by the owner of it (e.g. seeking rezoning) so it could thereafter be used in business. This situation commonly arises for aged care providers, for example, where a 'greenfield' site is acquired and left vacant and not physically used while the aged care provider seeks relevant zoning, etc, approvals for the construction of an aged care facility on the site. This process could take several years and is not guaranteed of success, meaning that it may not be permissible to construct an aged care facility on the greenfield site. Such an example may be contrasted with that covered by Example 7 in the Draft Ruling where the land is trading stock (as it would be of a developer or builder) or being *physically* used in business.

Application to SPVs

It is not uncommon for vacant land to be held by SPVs that do not fall under the categories of entities listed in s 26-102(5). The SPV can either be part of a group that has a broader business plan, or has its own business plan or profit-making venture.

This is most common for property developers in the private wealth market that purchase land through trusts with the intention of constructing and selling, or renting, the resulting property for a profit. During this process, the SPVs will likely hold the vacant land for a lengthy period of time while they finalise approvals and confirm details.

Noting that this is often a question of fact, we consider that the inclusion of a new section in the Draft Ruling which provides details of the various factors and evidence the ATO will examine when determining whether the land is being used, or made available for use, in these circumstances will assist taxpayers. The non-exhaustive list of factors and evidence could include:

- Third party evidence that can demonstrate an intention (e.g. bank loan documents and development applications);
- Costs incurred to begin or further a business or profit-making intention (e.g. costs paid in relation to preparing and submitting a development application);
- The SPV's business plan (if it exists); and
- The business of the broader group.

The inclusion of an example of a low-risk scenario may also assist in these circumstances. Guidance will better assist taxpayers and reduce the need for, and costs associated with, taxpayers who are low risk seeking private binding rulings in all instances.

Policy considerations

We note below some policy considerations that are not specific to any one section of the Draft Ruling. These are shortcomings in the law which result in unintended outcomes.

Affiliates

We acknowledge that the interpretation and interaction of s 26-102 with the 'affiliate' rule is a broader issue and not specific to s 26-102. However, this is of significant concern to The Tax Institute and our members. We have highlighted our concerns below.

The combined effect of ss 26-102(1) and (2) exclude land used in the course of a business that is carried on by 'your affiliate or an entity of which you are an affiliate'. It is acknowledged that the 'affiliate' concept is used across a number of areas of taxation law, yet there is a lack of clear guidance and understanding by taxpayers and their advisers in relation to the concept of 'affiliate'. There could be unintended consequences in using the concept of 'affiliate' for the purposes of the vacant land measures.

It is common, particularly in the context of primary production, for a taxpayer having reached or nearing retirement to transfer their primary production business to their adult child who continues to operate the business. That is, the taxpayer retains ownership of the primary production land and makes it available to their adult child to operate the business. Sections 26-102(8)–(9) were designed to provide exceptions in certain situations but they do not cover the above scenario if the land is not under lease, hire or licence to the adult child as a result of a dealing at arm's length. Dealings between parents and adult children may be at less than market rate or free of cost.

Further, the adult child would typically not be an affiliate of the land-owner and cannot be an entity 'connected with' the land-owner under s 328-125. As a result, the adult child is unlikely to be an entity described in s 26-102(2)(b), (c) or (d). This means the land-owner is unable to fall within the scope of s 26-102(2) and usually cannot apply the exclusions in ss 26-102(8) and (9). Accordingly, they cannot claim a deduction for the costs associated with holding the vacant land.

Despite this, there is a specific exception in s 26-102(2)(c) for children of the taxpayer under 18 years. We consider that it would be a rare circumstance where a child under 18 years would be carrying on a business on land owned by their parent. The concept of an exclusion for the spouse or child under 18 years of a taxpayer originated from the active asset test in the small business CGT concessions in Division 152. The wording of the exclusion provisions in s 26-102 illustrates the problems created when provisions designed for one purpose (i.e. integrity rules designed to regulate which entities can access a range of small business tax concessions) are used for another purpose. The grouping rules in s 328-125 and s 328-130 were never designed for scoping the exception of a provision designed to deny deductions for the costs associated with holding vacant land.

Our members have provided us with examples that they have seen in practice where the application of the proposed legislation would appear to result in inappropriate outcomes.

- **Example 1** – Five siblings inherit farming land from their parents, and the land is leased at market value to one sibling to operate the business. The expenses of holding the land would not be deductible to four of the siblings as the operator of the business would not meet the requirements of s 26-105(2) (i.e. not 'connected with' or an 'affiliate', nor a spouse or child aged under 18 of the business operator).

- **Example 2** – Land may be held by an entity controlled by the spouse of the controller of a business entity. It would appear from s 26-102(2) that in those situations where the land does not meet the substantive permanent building or structure test, unless there is an affiliate relationship, deductions relating to the land are denied as the business use exclusion from the provisions does not apply to entities controlled by a spouse of the taxpayer. This is an inappropriate outcome and evidence of a broader issue that should be reviewed and reassessed.
- **Example 3** – The impact on owners of farming land who do not themselves carry on the farming business but allow a related party to do so is not clear and needs to be considered in detail. Based on the proposal, we have concerns in relation to the reliance on the 'connected with' and 'affiliate' tests in the following situations:
    - Farming land owned by a self-managed superannuation fund (**SMSF**);
    - Farming businesses conducted by a discretionary trust from which the land-owners do not receive at least 40% of the distributions of income or capital in at least one of the preceding four income years, nor do the land-owners control the trustee; and
    - Farming business conducted by the children or partnerships of children (and/or their spouses).

  In the first two instances, neither the SMSF nor the trust will be connected with the land-owner, nor could they be their affiliate. In the third instance, the test for determining whether an entity is an affiliate is a subjective one, looking at various factors relating to how the land-owner interacts with the children. This creates uncertainty that may require land-owners to undertake detailed analysis in making an assessment and would possibly involve obtaining costly professional advice.
- **Example 4** – The requirement in the law that the business be carried on by an entity connected with, or an affiliate, a spouse or child of, the land-owner is very restrictive. Further, it could potentially create family succession issues, especially where a primary production business is involved. It could be the case that the parent(s) retain ownership of the property but transfer the business to one or more adult children who operate it from the property at less than market rates, or if at market rates, the land contains residential premises. In this case, the requisite connection between the land-owner and the business operator for deductibility of legitimate holding costs may not exist.

The affiliate provisions and the vacant land measures do not operate effectively or in co-ordination with each other. We consider that the ATO could choose to adopt a similar approach for adult children as taken for short term absences[1] as an interim solution until an appropriate legislative outcome can be determined. That is, the ATO will not apply compliance resources to those circumstances where a land-owner makes their vacant land available to their adult child for the purposes of using the land for primary production.

[1] See example 12 of the Draft Ruling

Unintended outcomes for s 26-102(9)

Where vacant land is in use in carrying on a business (and meets the other conditions set out in s 26-102(9)[2]), deductions for the holding costs are not denied. However, the exclusion in s 26-102(9) is available only where the user of the land carries on a business, so deductions are still denied where the land is rented to someone who is not carrying on a business.

If the land is rented to someone for a private purpose, the exception in s 26-102(9) cannot apply. This can arise, for example, where an owner allows someone to use the land for private agistment of domestic animals. However, this private purpose is that of the lessee and not of the taxpayer who is genuinely holding the land for the purpose of gaining or producing assessable income. The taxpayer is required to declare the rent as assessable income but is denied the associated deductions. This is contrary to the intent and operation of s 8-1 which allows a deduction for losses and outgoings incurred in gaining or producing assessable income.

The current law has adverse unintended consequences for those who do not fall under the exemptions but who are using the land for an unequivocal taxable purpose that does not rely on taxpayer assertions to evidence the taxable use.

[2] That is, the land is under lease, hire or licence to another entity as a result of a dealing at arm's length, does not contain residential premises and residential premises are not being constructed on the land.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.